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"The Market as Interpreted under the Dow Theory"

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A SPECIAL STUDY

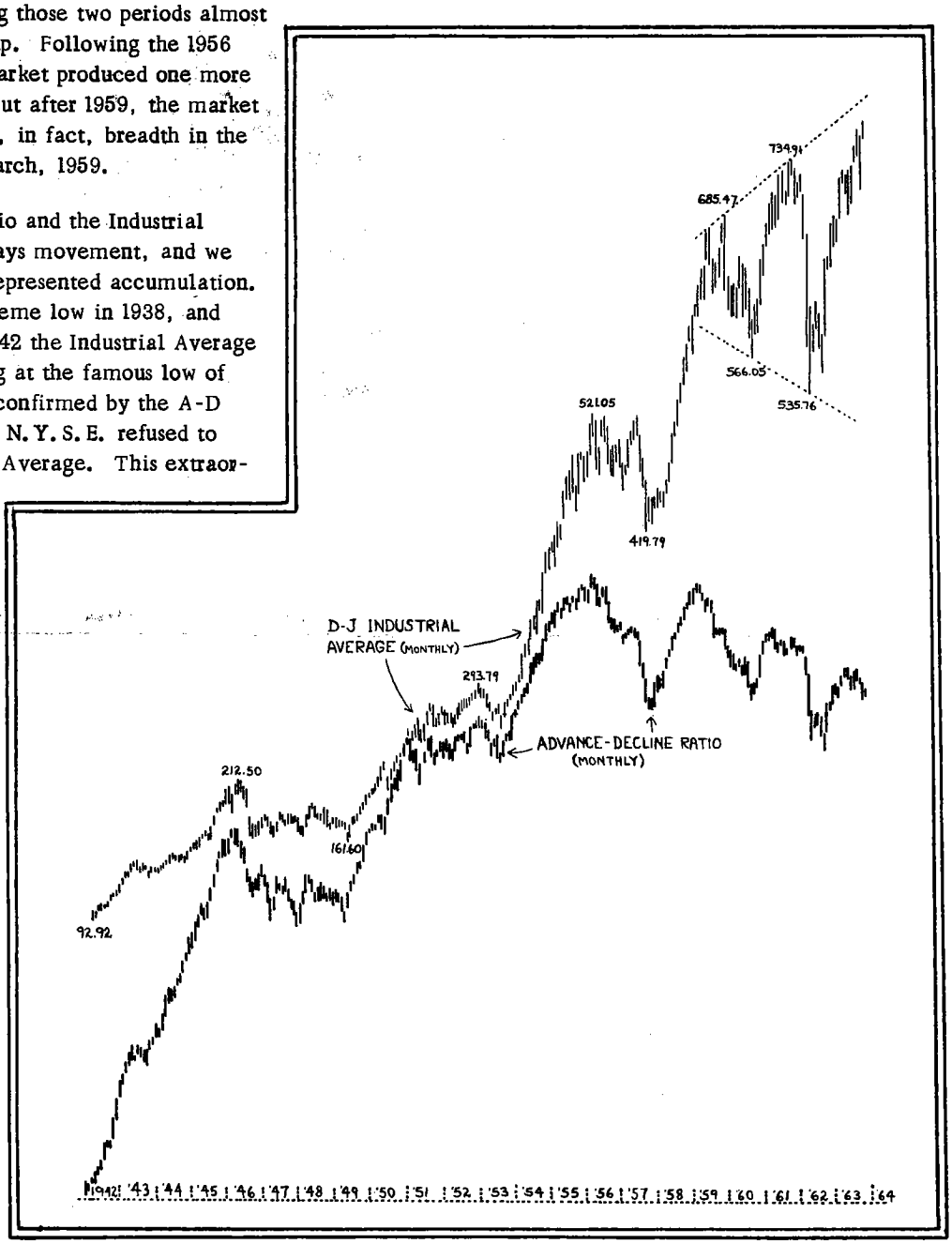
EXTRAORDINARY PICTURE Chart # 3 is a rare study which has not (to my knowledge) been published anywhere before. It is a monthly chart of the advance-decline ratio and the Industrial Average for the period of 1942 to the present. The monthly A-D ratio is constructed by simply drawing a vertical bar which connects the highest daily A-D figure and the lowest daily figure for each respective month. The huge panorama provided by this monthly chart underscores the drama which is now unfolding on the N. Y. S. E. We are witnessing (in my opinion) one of the most exciting periods in the history of the Exchange.

The 1942-46 and 1949-56 advances represented the most massive rises in "breadth" (A-D ratio) of which we have any record (and the records go back to 1916). During those two periods almost every stock on the Board was on its way up. Following the 1956 peak and subsequent 1957 decline, the market produced one more great rise in breadth (During 1957-59). But after 1959, the market became a good deal more selective, and, in fact, breadth in the major sense turned decisively down in March, 1959.

During the period of 1938-42 the A-D ratio and the Industrial Average fluctuated in an extended sideways movement, and we now know that this sideways movement represented accumulation. Actually, the A-D ratio recorded its extreme low in 1938, and that low was not again broken. But in 1942 the Industrial Average sank below its own 1938-41 range, closing at the famous low of 92.92. The 1942 Industrial low was not confirmed by the A-D ratio. Thus the majority of issues on the N. Y. S. E. refused to confirm a four-year low in the Industrial Average. This extraordinary non-confirmation completed the technical base for the great 1942-46 rise.

During 1946 to 1949, the 1938-42 basing action was repeated. The A-D ratio (see chart) recorded its extreme low in 1948. But the following year, in 1949, the Industrial Average cracked its entire 1946-49 trading range on the downside, closing (June 13, 1949) at an extreme low of 161.60. The A-D ratio would not confirm the Industrial penetration, and the breadth indicator held stubbornly above its 1948 bottom. Thus, the majority of issues on the N. Y. S. E. (as measured by the A-D ratio) again refused to confirm a three-year low in the Industrial Average. This non-confirmation completed the technical base for the next tremendous rise in breadth and the Averages.

Note that the peak of the new advance was recorded by the A-D ratio in 1956, and this peak was almost equaled during



the subsequent 1957-59 advance. It was in the year 1959 that the Industrial Average commenced formation of a remarkable pattern — a giant "broadening structure."

A broadening pattern is a five-point reversal formation. But unlike the normal triangle in which each successive swing diminishes in extent, the broadening pattern produces a series of swings in which each peak is above the previous peak and each low is below the preceding low. The broadening pattern in itself is an expression of a market out of control, a market which is being "whipped up" by extraordinary events, rumors, and excitement. The broadening formation is characteristic of the late stages of an upward movement, and its wildly expanding swings are the very opposite of the quiet sideways action which we usually associate with a major bottom.

Note (on chart) that the broadening structure in the Industrials has formed against a pattern of steady retreat in the A-D ratio. In fact, since 1959 the relationship of breadth and price have been the exact opposite of that which occurred during the accumulative periods of 1938-42 and 1946-49.

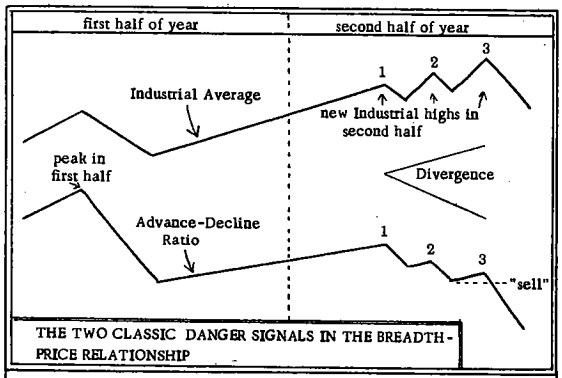
The A-D ratio since 1959 has shown an inability to confirm at the successive major Industrial peaks of 1959, 1961, and 1964. On the other hand, the A-D ratio has shown a willingness to lead the Industrial Average on the downside during 1959, 1961 and 1963. It was during the 1962-crash that the A-D ratio "spoke" with ominous authority. During the spring market collapse of 1962 the A-D ratio broke below its 1957 and 1960 bottoms, thereby sinking to a five-year low. The Industrial Average during 1962 held well above its own 1957 low of 419.79, and this undoubtedly provided the technical strength for the subsequent 1962-64 rise.

But as seen on the chart, each upward movement in breadth since 1953 has been less impressive than the preceding movement. Compare the "yardage" covered by the Industrial Average since 1953 with the comparable swings in the A-D ratio. The picture is clear — the general market as measured by the A-D ratio is growing progressively more "tired".

CONCLUSION: What conclusion can we draw from this long-term chart of monthly breadth-price action? Here is one conclusion of which I am convinced: just as stubborn strength in the A-D ratio during 1938-42 and 1946-49 resolved itself into a massive upward movement in the general market, so persistent weakness in breadth since 1959 will resolve itself into major weakness in the general market (probably beginning some time in 1964). When that occurs, I believe the ensuing decline will be of greater diminsions than anything seen by this generation.

* * * * *

The chart at right was first published in Letter # 241. I am taking the liberty of reprinting it since it describes in detail the two classic danger signals which may present themselves in the breadth-price relationship. I urge all of my subscribers to study this chart and become thoroughly familiar with its contents.



THE TWO CLASSIC DANGER SIGNALS IN THE BREADTH-PRICE RELATIONSHIP

The first danger signal is illustrated as breadth (the A-D ratio) records its annual peak in the first half of the year while the Industrial Average goes on to establish successive (unconfirmed) highs during the second half of the year. The second danger signal is a full breadth-price divergence as signified by the successive peaks labeled 1, 2 and 3 on chart. Both indicators record highs at point 1. At 2 Industrials rise to a new high but at 2 the A-D ratio fails to better its own preceding peak at 1. The process is repeated at peak 3, following which both indicators turn down. The divergence is completed and a "sell-signal" is given when (following point 3) the A-D ratio breaks to a new low as shown on chart.